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Appropriated surplus

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fusing to set out separately in the consolidated balance sheet the excess cost, whether so described, or as good-will. The tendency is to hide the amount by including it with property, or in some other way including it so that it is indistinguishable.

Finally, there is the reverse of the second situation, rarely encountered it must be admitted, where the cost of the investment to the acquiring company is less than the net worth of the company acquired. This situation represents a favorable purchase, the reason for which may be difficult to assign, but one which has been known to result from the exercise of rights to call classes of stock carrying with them the rights to surplus.

Ignoring the questions of over valuation and under valuation, and considering the treatment which should be accorded to surplus at date of acquistion when the net asset values of the subsidiary are in excess of the cost to the company acquiring the investment, it seems that the answer must depend upon the character of the surplus. If the excess of net worth over cost to the parent company is represented by what was capital surplus before consolidation, it must remain capital surplus after consolidation. If such surplus was earned surplus before consolidation, it loses no part of its character as surplus available for dividends by the mere fact of consolidation. The dividend test which dictated against taking surplus at date of acquisition into consolidated surplus, clearly indicates in the present situation that any earned surplus of the subsidiary, properly may be treated as consolidated earned surplus, available for dividend appropriations. The desirability of drawing a line of demarcation between the operating efforts of the management before and after consolidation seems not to be sufficient justification for capitalizing such surplus as of the date at which the newly acquired company passes into the consolidated group.

There is yet one possibility in connection with the third situation which must be taken into consideration. That possibility is that the amount invested by the holding company will be less even than the amount represented by the par value of the capital stock of the subsidiary. Inasmuch as the amount involved in the investment of the holding company is tantamount to a payment to outsiders for their interest in the net worth of the subsidiary, it would seem that the excess of par over cost to the parent should remain, after elimination of cost against capital stock, as capital surplus, and that any excess beyond par represented by earned surplus should remain after consolidation as earned surplus.

Appropriated Surplus

A QUESTIONNAIRE issued by the American Institute Committee on Definition of Earned Surplus has excited a considerable amount of interest, and been the means of developing much interesting discussion.

One question, relating to surplus appropriated for the retirement of preferred stock, not only has aroused argument in its own behalf, but has revived a controversy of long standing concerning the analogy of sinking funds "created out of profits."

"Should surplus appropriated for the retirement of preferred stock under the provisions of a preferred stock agreement be considered as permanently appropriated until the entire issue of preferred stock has been retired?" Such is the question of the Institute Committee.

The analogous question for which the committee is not responsible is as follows:

"Is it necessary, in case an indenture provides that a sinking fund shall be created out of profits, to transfer out of earned surplus into a reserve, an amount equal to the sinking fund deposit, and if so, how long should the reserve be kept standing?"

The assets of a business are derived from three sources:

(a) Contributions of capital
(b) Borrowings
(c) Profits

Funds applied in any reduction of a liability to borrowers, obviously, must come from contributions of capital, or from profits, or from other borrowers.

Funds applied in any reduction of a shareholder's interest may come from the release of funds which the shareholder himself contributed, from borrowings, or from profits.

An agreement calling for the retirement of preferred stock, or of bonds, need not specify the source of the funds which are to be used for such purpose. How they may be raised does not concern the prospective recipients. That they exist, will be available, and will be forthcoming at the appropriate time is the matter of interest. Whether or not there are sufficient profits in the meantime to cover the capital liquidation is not important, in the last analysis, to the beneficiaries. Theirs are rights, contractual in their nature, to receive certain sums, at certain dates, in settlement of their capital interests.

An agreement to provide out of surplus, or earned surplus derived from profits, for the retirement of preferred stock, or of bonds, does not insure such retirement. The amount of profits may not be sufficient to permit of such procedure. If the agreement to retire stock is contingent upon profits, the stock may or may not be retired.

With bonds the situation is different. The bonded obligation must be met at maturity. The cash with which to make the settlement must be procured, but how, or whence, is not strictly relevant. And whether or not there have been profits is beside the point. The mere fact that an indenture provides for a sinking fund to be created out of net profits does not postpone the day of reckoning merely because it may happen that there have been no net profits.

An agreement to set aside a sinking fund does not, in the absence of specific provision therefor, require that there shall have been profits before sinking fund deposits may be made. It does not stipulate the source from which the funds shall be obtained. The effect on the total amount of assets is nil. When the sinking fund is applied, capital liabilities are extinguished out of cash, the source of which is immaterial. The total assets and the total liabilities have been reduced in equal amounts.

The setting aside of cash in a separate fund accomplishes all that can be accomplished, whether or not an agreement specifies that surplus shall be appropriated, or profits shall be charged to provide for retirement of the capital interests. But the appropriation of surplus, or a charge against profits, does not insure the payment of the obligation. Appropriations of surplus, or a charge against profits, in itself merely prevents surplus from being appropriated for dividends, or other purposes, to the extent of the charge.

The controversial point, on which there are decided differences of opinion, is what disposal should be made of the appropriated surplus or of the reserve for sinking fund, after the capital obligation has been discharged. One view is that the reserve, or appropriated surplus, having served to protect the beneficiaries against the use of funds for purposes other than the liquidation of their claims, reverts to earned surplus. The other view is that the reserve, or appropriated surplus, may be closed out only to capital surplus.

The effect of appropriating earned surplus for the retirement of preferred stock is to designate that profits shall be used for the purpose. Profits used for the retirement of one class of capital interest add to the capital interest of those remaining. The retirement, out of profits, constitutes the substitution of one capital interest for that of another. Profits may not be used for the purchase of an additional capital interest and also withdrawn as dividends.

The effect of retiring a capital interest out of profits is shown in the following illustrations:

FIRST SITUATION

Invested assets...	$200,000	Equity of bondholders.......	$100,000
		Equity of shareholders.......	100,000
	$200,000		$200,000

SECOND SITUATION

Invested assets...	$200,000	Equity of bondholders.......	$100,000
Cash from profits.	100,000	Equity of shareholders........	200,000
	$300,000		$300,000

THIRD SITUATION

Invested assets...	$200,000	Equity of shareholders........	$200,000

Briefly and succinctly stated, the foregoing illustrations show that the profits belonged to the shareholders until the shareholders used the profits to purchase the equity of the bondholders.

The conclusion must be reached, it seems, that appropriated surplus, or a reserve for sinking fund, does not automatically revert to earned surplus which is available for dividends when the purpose for which the appropriation or reserve was created has served its purpose. It may be capitalized by means of a stock dividend, or it may be refunded by a capital issue, in which latter case profits previously used for the purchase of a capital equity are recovered out of the resale of the equity and thus become available for dividends. A distinction should be made, probably, between recovering the profits through the sale of a capital interest, and borrowing on current account for the purpose of paying a dividend. The latter does not release the profits from the capital account.

While appropriated surplus does not revert to earned surplus except through the channels indicated, there seems to be no reason why such steps may not be taken from time to time as the capital obligation is liquidated without waiting until the entire process of liquidation has been completed.

Additions to the Library

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